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Nos. 129 and 130

In the Supreme Court of the United States

October Term, 1944

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[illegible]

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE [illegible] CIRCUIT

[illegible]

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In the Supreme Court of the United States

OCTOBER TERM, 1944

No. 129

ROBERT W. JOHNSTON, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

No. 130

T. ALICE KLAGES, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court of the United States (R. 19–44) [1] is reported in 1 T. C. 228. The opinion of the Circuit Court of Appeals (R. 59–65) is reported in 141 F. 2d 208.

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[1] All record references will be to the *Johnston* case unless specifically designated otherwise.

JURISDICTION

The judgment of the Circuit Court of Appeals in the *Johnston* case was entered on March 10, 1944 (R. 66). The judgment in the Circuit Court of Appeals in the *Klages* case was entered on March 10, 1944 (Klages, R. 62). The petition for writs of certiorari was filed on June 5, 1944. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Both taxpayers were income beneficiaries of a trust created by their mother. Part of the corpus of the trust consisted of a mortgage which the trustees foreclosed, and later bid in. In the taxable year the trustees sold the property at a loss. But in accordance with the law of New York the trustees allocated to the taxpayers as income beneficiaries a portion of the proceeds of the sale in lieu of the income they would have received in the way of interest if no default had occurred. The question presented is as follows:

Whether the portion of the proceeds of sale allocated to the taxpayers by the trustees during the taxable year constitutes income under Section 162 (b) or Section 22 (a) of the Revenue Act of 1936, or under the Sixteenth Amendment.

STATUTE PRESENTED

The statute involved is set forth in the Appendix, *infra*, p. 8.

STATEMENT

The facts as stipulated (R. 1, 31) and as found by the Tax Court (R. 22–31) may be summarized as follows:

Both taxpayers were life beneficiaries under a trust created in 1921 by their mother, under which they were entitled to "the net income" during their respective lives. The corpus of the trust consisted of real estate located in the City of New York. (R. 23–24.)

In 1924, the trustees sold this property and in part payment took back a bond in the principal sum of $600,000, secured upon the property sold. In 1932, the mortgagor defaulted in the payment of interest upon this mortgage and the trustees foreclosed, bidding in the property in December of that year for $600,000. There were then due upon the bond for principal and interest about $628,500,[2] and the expense of foreclosure and unpaid taxes came to about $27,000 in addition. (R. 25.)

On January 11, 1937, the trustees sold the property so bid in for $550,000—$100,000 in cash and $450,000 in a purchase money mortgage (R. 26). The accumulated interest due upon the principal sum of $600,000 from February 1, 1932, to the date of sale by the trustees on January 11, 1937, was about $163,000; so that that part of

[2] $600,000 principal and interest at the rate of 5½ percent from February 1, 1932, until December 13, 1932 (R. 25).

the purchase price of $550,000 to which the life tenants were entitled, if the purchase price were to be divided proportionately between principal and accrued interest, was a little over 21 percent (R. 27). The trustees divided the cash received in that proportion, each beneficiary receiving his or her share in 1937. They also credited the same proportion of the mortgage for $450,000 to the two beneficiaries. Three payments in reduction of the principal of the mortgage which were made in 1937, were also divided in the same manner and the proper share was turned over to each beneficiary. (R. 28–29.)

In their fiduciary return the trustees did not treat any part of these payments as income of either the trusts or the taxpayers, nor did the taxpayers themselves in their individual returns include them in their gross income (R. 20–21, 30–31). The Commissioner sent each of them a deficiency notice upon the ground that the cash which they received and the value of that portion of the mortgage which had been credited to them should be included in their gross income, because it was distributable to them under the trust created by their mother (R. 13–16). In their appeal to the Tax Court the taxpayers contended that since $550,000 was less than the bid upon which the trustees had bought in the property at the foreclosure in 1932, it was impossible to say that they had received income of any kind; that

the payments actually made or credited to them came out of proceeds of the sale of principal, and even though the law of New York allotted a part of those proceeds to them as an equivalent of the interest which they would have received if the original mortgage had still remained in existence, that could not make income out of what was not in fact income. The Tax Court decided that under two decisions of the Court of Appeals of New York,[3] according to which 21 per cent of the proceeds of sale was paid or credited to each taxpayer, the amounts so paid or credited to each taxpayer constituted income. One judge dissented and two others dissented in part. Appeals were taken to the Circuit Court of Appeals, which affirmed the decision of the Tax Court.

ARGUMENT

The findings show that the amounts involved were distributable, under local law, to the taxpayers under the will of their mother, which provided that they were entitled to "the net income" of the trusts during their respective lives (R. 23–24). Thus taxpayers were entitled only to income and received the distributions only because of their status as income beneficiaries. The result here is therefore consistent with *Burnet* v. *Whitehouse,* 283 U. S. 148; *Helvering* v. *Butterworth,* 290 U. S. 365; and *Lyeth* v. *Hoey,* 305 U. S. 188, which plainly hold that the capacity in which the

[3] *In re Chapal*, 269 N. Y. 464, and *In re Otis*, 276 N. Y. 101.

recipient stands with respect to a trust or estate, is determinative.

Section 162 (b) of the Revenue Act of 1936 (Appendix, *infra*) expressly provides that trust income which is to be distributed currently to the beneficiaries shall be included in computing the net income of the beneficiaries. Since the taxpayers were income beneficiaries and the amounts in question were distributed to them in accordance with the terms of the trust, the amount should be included in computing their net income. If, for any reason, Section 162 (b) does not apply, Section 22 (a) of the same Act (Appendix, *infra*), which defines gross income as including income derived from any source whatever, would seem to cover the amounts received by the taxpayers during the taxable year.

The theory upon which the trustees made the distributions was that a pro rata percentage of the receipts was to be regarded as in lieu of income. Therefore, the result is also consistent with the principle that receipts in lieu of income may properly be regarded as income. *Hort* v. *Commissioner,* 313 U. S. 28; *Andrews* v. *Commissioner,* 135 F. 2d 314 (C. C. A. 2d), certiorari denied, 320 U. S. 748.

The decision below is also supported by *Plunkett* v. *Commissioner,* 118 F. 2d 644 (C. C. A. 1st), where a life tenant under a testamentary trust was held to be taxable upon an amount

claimed and received as the equivalent of that which would have accrued as income had the trust property been properly invested.

CONCLUSION

There is no conflict of decisions and the petition for certiorari should be denied.

Respectfully submitted.

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